22.02 Steps in Applying the Acquisition Method

Overview

All consolidations must be performed using the **acquisition method.** (ASC 805) An acquisition is considered to be a financial transaction executed by the Acquirer, and the resulting entity is considered to be a continuation of the Acquirer. As a result, the assets and liabilities of the Acquiree are acquired at **fair values** (ASC 820) at the **acquisition date,** and **income** of the Acquiree is only included from the **date of acquisition on.**

There are **four steps** in applying the acquisition method.

Identify the Acquirer

In a stock-for-assets transaction, the acquirer is the one giving the assets and acquiring the stock. In stock-for-stock transactions, however, various factors will be considered in determining which entity is the acquirer and which is the acquiree. Factors to consider may include:

- The entity that initiated the transaction
- Representation in management and governance
- Relative voting rights

Identifying the acquirer can be very significant since the assets and liabilities of the acquirer remain at book value and those of the acquiree are reported at fair value.

Determine the Acquisition Date

The acquisition date is the date on which the acquirer obtains a **controlling** financial interest over the acquiree. In the case of an equity acquisition, it is the date on which the acquirer's holdings became a majority. In the case of a VIE, it may be the date on which a lease, a sale or purchase contract, or some other relationship was entered. The acquisition date is also referred to as the **measurement date.** It is the date as of which:

- Identifiable assets acquired and liabilities assumed are measured at fair value by the acquirer.
- The acquirer begins to recognize the revenues and expenses of the acquiree in the acquirer's consolidated F/S.

Recognize and Measure Identifiable Assets Acquired, Liabilities Assumed, & Noncontrolling Interest

Identifiable assets, including those that are and are not included on the F/S of the acquiree, and liabilities assumed are generally measured at **fair value.** Other measurements are based on prescribed standards.

In some cases, the acquirer will **not recognize** assets or liabilities that are included in the F/S of the acquiree. Examples include:

- Any goodwill recognized on the F/S of the acquiree.

- Prepaid rent or accrued rent resulting from recognizing operating lease payments on a straight-line basis.
- Deferred tax assets or liabilities, which will be measured by the acquirer on the basis of the differences between the newly recorded amounts and the tax bases of assets acquired and liabilities assumed.

Identifiable Intangible Assets

The acquirer recognizes all identifiable intangible assets at fair value at the date of acquisition. An intangible is considered identifiable if either:

- It represents a legal or contractual right; or
- It can be sold, transferred, licensed, or otherwise disposed of by itself.

Examples of newly created identifiable intangibles include:

- **Marketing-related intangibles** – Trademarks, trade names, noncompetition agreements
- **Customer-related intangibles** – Customer lists, customer contracts
- **Artistic-related intangibles** – Plays, operas, books, magazines, pictures, videos, films, music
- **Contract-based intangibles** – Licensing, royalty, advertising, lease and franchise agreements, construction permits
- **Technology-based intangibles** – Computer software, mask works, trade secrets, recipes

Private Company Alternative

Nonpublic entities may elect to **not recognize noncompetition agreements and customer-related intangibles** that cannot be sold or licensed separately. This effectively increases the amount recognized as goodwill or decreases the amount reported as a gain on bargain purchase.

An electing entity must amortize goodwill.

Noncontrolling Interest

The acquirer also recognizes any noncontrolling interest in the acquiree at fair value. **Fair value** is considered to be market price of a single share multiplied by the number of shares on the acquisition date. A **noncontrolling interest** results from the acquirer having a controlling financial interest that is not 100% of the voting equity of the acquiree.

- In the case of a stock acquisition, the noncontrolling interest would be the portion not owned by the acquirer (ie, the minority interest).
- In the case of a VIE, it may be 100% of the ownership of the entity.

The noncontrolling interest is a component of stockholders' equity and is required to be reported in the **stockholders' equity section** of the balance sheet. (ASC 810) The amount reported as the noncontrolling interest is periodically adjusted for its share of net income and other comprehensive income:

- Net income will include all revenues, expenses, gains, and losses of the parent and all subsidiaries, after adjusting for intercompany items.
  - An appropriate amount will be allocated to the noncontrolling interest on the income statement (I/S) and will be closed to the noncontrolling interest account.
  - The remainder will be allocated to the parent and will be closed to retained earnings.

- Other comprehensive income will include all amounts recognized by the parent and all subsidiaries, after eliminating intercompany items.
  - An appropriate amount will be allocated to the noncontrolling interest on the statement of comprehensive income and will be closed to the noncontrolling interest account.
  - The remainder will be allocated to the parent and will be closed to accumulated other comprehensive income.

Recognize and Measure Goodwill/Gain From Bargain Purchase

The acquirer will recognize consideration given, if any, at its fair value.

- Any assets transferred are included at fair value with any difference between fair value and book value treated as a gain or loss on disposal.
- Stock issued is recognized at fair value with a credit to common stock for any par or stated value and additional paid-in capital for the difference.

Most **costs incurred** in relation to the transaction will be **recognized as expense** when incurred. This includes:

- Any general expenses incurred
- Costs directly related to the acquisition, such as attorney or appraiser fees
- Indirect costs, such as the costs of printing new stationery or developing new training manuals, finder fees

One **exception** is the cost of issuing and registering debt and equity securities issued in the combination.

- Costs of issuing equity securities reduce additional paid-in capital.
- Costs of issuing debt securities are capitalized and amortized as debt issue costs.

Considering all the factors involved in recognizing a business combination, and all the different measurements, it would be very unusual for the entry recognizing the combination to balance.

- If the amount necessary to balance the entry is a debit, it will be recognized as **goodwill.**
  - Goodwill is measured as the excess of the consideration given over the fair value of the underlying net assets acquired.
  - The fact that the consideration is greater indicates that the company as a whole is worth more than the fair value of its net assets.
- If the amount necessary to balance the entry is a credit, it will be recognized as **gain on bargain purchase**.
  - The gain is measured as the excess of the fair value of the underlying net assets acquired over the consideration given.
  - The fact that the consideration is less indicates that the company may not have been a going concern and may not have had the ability to dispose of assets and settle liabilities at their fair values.

The acquisition is recorded in one of two ways:

- The acquirer can record the individual assets acquired and liabilities assumed (ie, a merger), or
- Record the transaction as an investment.

The acquirer will often record the individual assets acquired and liabilities assumed when there is no need to maintain separate records for the acquiree, either for internal purposes or for external reporting purposes. When this is the case, the process is as follows:

- Assets acquired and liabilities assumed are recognized at their fair values.
- Consideration is measured as follows:
  - Cash paid is recognized as a reduction to cash
  - Stock issued is recognized at its fair value with the par value credited to common stock and the remainder to additional paid-in capital.
  - If other assets are transferred, consideration will be the fair value and a gain/loss is recognized as if they were sold for their fair values.
  - Any previous investment, if accounted for at adjusted cost or under the equity method, is also included at fair value with a gain/loss recognized as if sold for that amount.
- Noncontrolling interest, if any, is recognized as a component of stockholders' equity at its fair value.
- Any remaining **debit** necessary to balance the entry is recorded as **goodwill**.
- If a **credit** is necessary (paid less than net fair value for acquiree), the bargain is recorded as a **gain** on the I/S.

Once the initial entry has been recorded, the acquirer will apply GAAP going forward, and there is no special accounting required after the period of acquisition.